Office of Chief Counsel Internal Revenue Service

memorandum

CC: :TL-N-3353-99

date: June 22, 1999

to: Chief, Examination Division,

Attn:

from: District Counsel,

subject:

Unreasonable Compensation Adjustment

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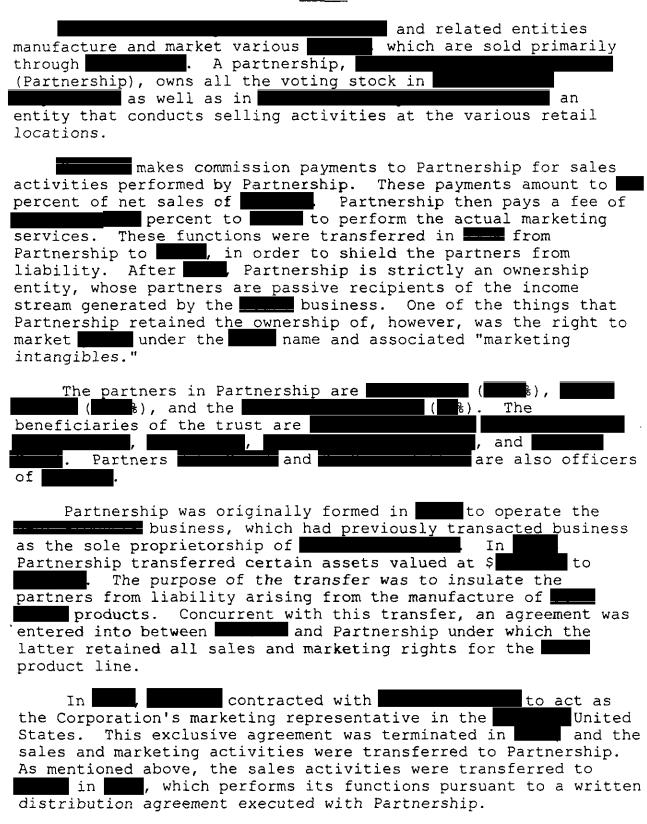
ISSUE

Should an unreasonable compensation theory be raised as an alternative basis for the proposed adjustment in this case?

CONCLUSION

No. It is unlikely that an unreasonable compensation adjustment will be sustained on these facts.

FACTS



makes crucial decisions as to the nature of the
product line (such as product ingredients and package designs, as well as decisions relating to basic advertising and pricing
policies). The essential strategy has been to position
products in the of the market.
pays most of the direct sales expenses involving advertising and displays, as well as costs associated with trade
shows. Compensation to the sales staff employed by is paid
by The marketing strategy of the organization has been successful. The annual growth in sales of products
averaged percent during the early 's, which is
considerably above the growth rate for the industry as a whole. 1
The two key players in the marketing arena are
and correctly vice-president, is the individual responsible
for initiating and maintaining the retailing
connection. The importance of this responsibility, as evidenced by the success of the overall marketing strategy, has been amply
reflected in his salary, which averaged \$ per year
during the early s.
is President of Over the years, he has
been involved in all aspects of the business. He may also be able to claim a portion of the credit for the success of the
marketing strategy. He receives a substantial salary, which
averaged \$ per year during the same period.
retail presence of products through the
market segment. is a market in the in its
retail locations. Since most consumers require considerable
assistance when purchasing the product, store personnel need to be knowledgeable about the products and comfortable in selling
the products. Presentation, attractive point of purchase
displays, and periodic training of store employees are critical
success factors in the
Average annual rates of growth of sales for industry
peers (SIC = for the 5 year period ending in were as
Average annual races of growth of sales for made of
peers (SIC = for the 5 year period ending in were as follows: percent;

database.

stores. The taxpayer believes that in-store sales support and service that the representatives provide is critical in the market and have enabled the product line to win the battle for

Some of the functions of the sales representatives (according to their job description) include the following:



LAW AND ANALYSIS

I.R.C. § 162(a) provides that

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered.

Treas. Reg. § 1.162-7(a) provides that

There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-7(b) provides that

The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. . . . 2

The fundamental problem with pursuing an unreasonable compensation argument in this case is that the payments at issue are not "paid in the form of compensation" for services performed by the officers. They are payments to Partnership for a services contract and for use of the trade name. If Partnership were not the historical entity, which has retained the valuable trade name, then it might be possible to apply the step-transaction doctrine. On these facts, however, that doctrine is clearly not applicable. See, e.g., American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam 177 F.2d 513 (3rd Cir. 1949); cert. denied 399 U.S. 920 (1950). The issue in the case will have to remain the reasonableness of the payments to Partnership as payments to a related entity. We have coordinated our position with the national office, and the national office concurs.

CONCLUSION

It is unlikely that an unreasonable compensation argument will succeed on these facts, and we recommend against developing it.



² Audit guidelines are set forth in The Internal Revenue Manual, Handbook No. 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations, Sub-SubSection 232.2, Officer's Salaries (Date document last amended: 3-11-1985).